United States Court of Appeals
for the Second Circuit

APPELLEE'S BRIEF

74-1643

United States Court of Appeals

For the Second Circuit.

MAX S. GUMER,

Appellant-Appellee,

vs.

SHEARSON, HAMMILL & CO., INCORPORATED,

Defendant-Appellee-Appellant,

WINSLOW, COHU & STETSON, INC.; FREDERICK S. NUSBAUM and THE NEW YORK STOCK EXCHANGE,

Defendants.

Brief of Defendant-Appellee-Appellant, Shearson, Hammill & Co., Incorporated.

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THE REPORTER COMPANY, INC., Walton, N. Y. 13856—607-865-4181—1974

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Preliminary Statement.

This is an appeal from an order of April 1, 1974, of Honorable Harold P. Burke, United States District Judge for the Western District of New York and from an order of the District Court of July 31, 1974, which modified, *nunc pro tunc,* the order of April 1, 1974.

The order of April 1, 1974, dismissed all of the causes of action of plaintiff's complaint alleging liability of defendant Shearson, Hammill & Co., Inc. (hereafter "Shearson") to plaintiff, Max S. Gumer (hereafter "Gumer") and declined plaintiff's request for leave to amend the complaint. The order of April 1, 1974, made no determinations with respect to the allegations against the other codefendants and contained no determination, pur-

suant to Fed. R. Civ. P. 54(b), that there was no just reason for delay and therefore did not direct entry of final judgment. Gumer appealed from that order.

Following the filing of a motion by Shearson to dismiss the instant appeal, Gumer requested, in chambers, a modification of the order of April 1, 1974, which modification was made by an order dated July 31, 1974. That order made a *nunc pro tunc* determination under Fed. R. Civ. P. 54(b) that there was no just reason for delay and that final judgment should be entered dismissing Gumer's claims against Shearson. Shearson then withdrew its motion and appealed from the order of July 31, 1974. Pursuant to stipulation Grumer and Shearson have requested that the appeals be consolidated.

Issues Presented for Review.

1. Did the court below abuse its discretion in finding that there was no just reason for delay and in directing entry of final judgment pursuant to Fed. R. Civ. P. 54(b)?

2. Under the facts of this case as alleged in the complaint did Shearson commit a violation of Regulation T, 12 C. F. R. §220 (hereafter "Regulation T") which gives Gumer a private right of action under the Federal Securities Laws?

3. Do the facts of this case as alleged in the complaint state violations of Rule 405 or Rule 431 of the New York Stock Exchange which give Gumer a private right of action under Federal Securities Laws?

4. Do the facts of this case as alleged in the complaint state a violation of SEC Rule 10b-5 (17 C. F. R. §240, 10b-5 hereafter "SEC Rule 10b-5")?

Statement of the Case.

Shearson, a corporation engaged in the brokerage of securities, is a member of The New York Stock Exchange and a broker-dealer registered with the Securities Exchange Commission.

This case arises out of transactions in securities accounts, including a margin account, which Gumer and his brother Lou Gumer maintained with defendant Winslow, Cohu & Stetson, Inc., and which were transferred to Shearson at the request of Gumer and Gumer's attorney. When transferred, the accounts contained more than 180 different security positions and were valued by plaintiff in his complaint in amounts from $2,500,000 to $4,000,000.

The circumstances surrounding Gumer's claim, as alleged against other defendants, in various counts of plaintiff's complaint, are as follows. (The Complaint is reproduced in Appellant's Appendix, p. A-1, *et seq.*) On July 29, 1969, Gumer was informed by Winslow that the accounts of his brother Lou Gumer (L. G. account) and of Pauline Rosenberg (P. R. account) were under margin (Paragraph Tenth). After Winslow made certain specific statements and representations as pleaded by Gumer (Paragraphs Tenth and Eleventh) and at Winslow's request, Gumer executed a guarantee of these accounts (Paragraphs Eleventh through Thirteenth). Gumer further alleges that his brother's accounts and those of Pauline Rosenberg contained securities which were purchased by Winslow in violation of Regulation T (Paragraphs Thirty-first and Thirty-second).

On August 1, 1969, Gumer received a margin call from Winslow based upon that guarantee (Paragraph Fifteenth). He met the margin call with a deposit of securities with a market value in excess of $450,000 (Paragraph

Seventeenth). Further calls were made by Winslow and a partial liquidation of Gumer's account was done by *Winslow* (Paragraph Nineteenth). Gumer then executed an agreement with *Winslow* surrendering certain of his rights and arranging for a scheduled sell-out of his securities (Paragraph Forty-second). Subsequent to that agreement, Gumer's account and the accounts of Lou Gumer and Pauline Rosenberg were consolidated by *Winslow* (Paragraphs Twenty-first, Thirty-eighth and Forty-second). The consolidated accounts were then transferred, at the request of Gumer and his attorney, to Shearson (Paragraphs Forty-sixth, Forty-seventh and Fiftieth) because Winslow was forcing liquidation of Gumer's account and because Gumer feared that Winslow was in imminent danger of financial collapse (Plaintiff's Brief, p. 5). Based upon the foregoing factual allegations, plaintiff has alleged violation by defendants other than Shearson of New York Stock Exchange Rule 431, SEC Rule 10b-5, Sections 6, 7 and 10 of the Securities Exchange Act (15 U. S. C. §78f, g and j) and Regulation T.

At the time plaintiff's accounts were transferred to Shearson, plaintiff entered into an agreement which provided in pertinent part

> 5. I will maintain such margins as you may in your discretion require from time to time and will pay on demand any debit balance owing with respect to any of my accounts. You may, in the event of my death or whenever in your discretion you consider it necessary for your protection, sell any or all property held in any of my accounts, cancel any open orders for the purchase or sale of any property with or without notice to me, and you may borrow or buy in any property required to make delivery against any sale effected for me. Such sale or purchase may be public or private and

may be made without advertising or notice to me and in such manner as you may in your discretion determine, and no demands, calls, tenders or notices which you may make or give in any one or more instances shall invalidate the aforesaid waiver on my part. At any such sale you may purchase the property free of any right of redemption and I shall be liable for any deficiency in my margined accounts.

10. * * * Any controversy arising out of or relating to my account, to transactions with you for me or to this agreement or the breach thereof, *shall be settled by arbitration* in accordance with the rules then in effect, of the American Arbitration Association or the Board of Governors of the New York Stock Exchange as I may elect. If I do not make such election by registered mail addressed to you at your main office within five days after demand by you that I make such election, then you may make such election. Judgment upon any award rendered by the arbitrators may be entered in any court having jurisdiction thereof. (Italics supplied.)

(See affidavit of Philip J. Hoblin, Jr., A-27, 28). Shearson duly demanded that plaintiff arbitrate the instant dispute. Plaintiff refused to proceed with arbitration (see affidavit of David W. Kelly, A-29, 30). Plaintiff then brought this action.

Gumer asserts two basic claims against Shearson. First he asserts in Count "Sixth" and in his brief that Shearson was a party to a continuous scheme of fraud, jointly and severally with the other defendants (Plaintiff's Brief, pp. 3, 31, Complaint A-21). In the complaint, however, his allegations of fact merely state that Shearson accepted the transfer of Gumer's accounts. Plaintiff alleges that in accepting the accounts Shearson violated Securities Exchange Act §§ 6, 7, 10 and 19; SEC

Rule 10b-5 (17 C. F. R. §240.10b-5); Federal Reserve Board Regulation T (12 C. F. R. §220); and Rules 405 and 431 of the Board of Governors of The New York Stock Exchange (see Count Sixth of the complaint, A-13 *et seq.*).

Gumer's second claim, set forth in Counts "Seventh" through "Eleventh," is that after transfer of the account and during the course of the stock market crisis in the spring of 1970, defendant Shearson failed to sell stocks out of plaintiff's accounts in sufficient amounts to maintain the margin in those accounts at minimum levels prescribed by Shearson's house rules and Rule 431 of The Board of Governors of the New York Stock Exchange. Plaintiff has alleged, as a basis for liability on this second claim, violations of Rule 431 of The Board of Governors of The New York Stock Exchange (Count Eighth) and of Securities Exchange Act §10 (15 U. S. C. §78j) and SEC Rule 10b-5 (Count Tenth) as well as negligence (Count Seventh), fraud and breach of fiduciary duty (Count Ninth) and breach of contract (Count Eleventh).

ARGUMENT.

POINT I.

The District Court abused its discretion in directing entry of final judgment.

Jurisdiction of this court over the instant appeal must lie in the provisions of 28 U. S. C. §1291. That section provides in pertinent part that the Courts of Appeals have jurisdiction to hear appeals "* * * from all *final* decisions of the district courts * * *" (italics added). Fed. R. Civ. P. 54(b) provides further that in

cases involving multiple parties or multiple claims, "* * * an order determining one or more but fewer than all of the claims, or an order determining the rights of fewer than all parties is not appealable as a final judgment * * * unless the district court expressly determines that there is no just reason for delay and expressly directs entry of judgment" (9 Moore's Fed'l Practice, p. 127, §110.09).

The order of the court of April 1, 1974, contained no such determination. After Shearson moved this court for an order dismissing the appeal, and before argument of that motion Gumer applied to the court below, and on July 31, 1974, Hon. Harold P. Burke granted pursuant to Fed. R. Civ. P. 54(b) an order, without decision, expressly determining that there was no just reason for delay and directing the entry *nunc pro tunc*, as of April 1, 1974, of final judgment between plaintiff-appellant, Max S. Gumer and defendant-appellee, Shearson, Hammill & Co., Incorporated. It is this final judgment dismissing the complaint as to Shearson from which plaintiff appeals. Shearson appeals from that portion of the order of July 31, 1974, which determined pursuant to Rule 54(b) that final judgment should be entered. This court may review such a determination. *Sears, Roebuck & Co. v. Mackey*, 351 U. S. 427, 437.

Plaintiff's complaint against Shearson is based upon two distinguishable factual matrices. First, Shearson is alleged to have participated with defendants Nusbaum; Winslow, Cohu and Stetson, Inc.; and the New York Stock Exchange in the wrongful consolidation and transfer of plaintiff's accounts. Plaintiff asserts that these activities were undertaken in succession, and severally and jointly by all defendants and that all of the defendants are jointly and severally liable for the total amount of his loss. Second, Shearson is alleged to have mis-

managed these accounts after their consolidation and transfer. Again, Gumer asserts these activities were undertaken in succession and severally and jointly by all defendants (cf. Gumer's brief, p. 3; Complaint, p. A-21) and that all defendants are jointly and severally liable for his losses, Complaint Paragraphs Twenty-first, Twenty-ninth, Thirty-eighth, Forty-third). The allegations of the complaint are still pending as to all defendants except Shearson.

The power granted to a district judge to make the determination under Fed. R. Civ. P. 54(b) that there is no just reason for delay and to direct the entry of final judgment is addressed to the sound discretion of the district judge (6 Moore's Federal Practice, p. 334, 54.27 [3]). This "sound discretion" should be exercised only when there is "some danger of hardship or injustice through delay which would be alleviated by immediate appeal." *Campbell v. Westmoreland Farm, Inc.*, 403 F. 2d 939, 942 (2d Cir. 1968). Indeed, Rule 54(b) orders should not be entered routinely or as a courtesy or accommodation to counsel * * * (and) should be used only 'in the infrequent harsh case' as an instrument for the improved administration of justice * * *" *Panichella v. Pennsylvania Railroad Company*, 252 F. 2d 452, 455 (3d Cir. 1958).

This court in *Campbell, infra,* at p. 942, sets forth the proper criteria for determining if a trial court has abused its discretion in certifying an order pursuant to Fed. R. Civ. P. 54(b). The proper tests for issuance of a Rule 54(b) certificate are: 1) whether immediate appeal will delay the trial, 2) whether immediate appeal will eliminate unnecessary evidence, 3) confine the issues, 4) shorten the trial, 5) save much expense to litigants, 6) expedite the work of the trial court; and 7) whether

plaintiff's recovery would be jeopardized or prejudiced if immediate appeal were not granted.

These factors are to be balanced against the policy against piecemeal appeals expressed in 28 U.S.C. 1291.

In this case the liability of the defendants has been alleged to be joint and several. As Judge Anderson of this court said in his dissenting opinion in *Build of Buffalo, Inc., v. Sedita*, 441 F. 2d 284, 294 (2d Cir. 1971):

> "* * * the adjudication of piecemeal appeals involving some but not all the defendants may operate to determine issues common to all the defendants without a corresponding opportunity for all the defendants to participate in that determination. *Zangardi v. Tobriner*, 116 U. S. App. D. C. 350, 330 F. 2d 224 (C. A. D. C. 1964); *Robbin v. American University*, 117 U. S. App. D. C. 351, 330 F. 2d 225 (C. A. D. C. 1964)."

Plaintiff has pleaded the same theories of federal securities laws violations against all the defendants, has alleged joint and several liability and has asserted a scheme among all the defendants. To hear this appeal now would only duplicate the appeals which will follow the trial court's determinations as to the liability of the other defendants.

Furthermore, the policy of this court against piecemeal appeals is not overcome by the circumstances of this case (see *Panichella, infra*, at p. 455). As shown above, all counts of plaintiff's complaint are still pending and viable against the remaining defendants. Plaintiff has not shown satisfactorily that an immediate appeal is necessary. As in *Campbell, infra*, the instant appeal will only

delay the trial of this matter. The instant appeal will not eliminate unnecessary evidence, confine the issues, shorten the trial, save expense, or expedite the work of the trial court. Indeed, all pretrial discovery must be held in abeyance while the appeal is decided, since such discovery could otherwise result in duplicate discovery and exorbitant expense to the parties. Furthermore, plaintiff's potential recovery would not be jeopardized or prejudiced by a refusal to hear this appeal *at this time*. Plaintiff can have full recovery from other defendants according to the theories pleaded in his complaint.

As in *Campbell, infra,* this court should await *final* determination of all of the issues between all of the litigants, before hearing this appeal. Given this court's strong policy against piecemeal litigation and given the tests enumerated in *Campbell, infra,* it is respectfully submitted that the trial court's determination pursuant to Fed. R. Civ. P. 54(b) was an abuse of discretion; that the determination pursuant thereto should be vacated; and this case remanded to the District Court for trial.

POINT II.

Plaintiff has failed to plead a violation of Regulation T which gives rise to a private right of action.

The gravamen of the complaint and the sum and substance of the facts pleaded to show a violation of Regulation T are contained in Paragraphs Forty-seventh, Fifty-third and Sixty-seventh of the complaint. In Count Sixth Gumer simply alleges that Shearson had or should have had actual knowledge that the P. R. and Louis Gumer (plaintiff's brother's) accounts were generated in violation of Regulation T and further that Shearson by its

acceptance of the consolidated Gumer account perpetuated a violation of Regulation T. In Count Eighth Gumer simply alleges that Shearson allowed his account to deteriorate into a deficit position and thereby violated Regulation T. Against these bare and conclusory pleadings, plaintiff would have the court apply the "principle and mandate" of Regulation T and *Pearlstein v. Scudder & German*, 429 F. 2d 1136 (2d Cir. 1970), cert. denied 401 U. S. 1013 (1971) (Plaintiff's Brief, Point I).

Count Sixth.

In his legal analysis of the application of Regulation T to Count Sixth Gumer begins with Section 3(b), the basic operative section of Regulation T, and proceeds with a long discussion of the obligation of the broker maintaining an account at the time of a purchase of securities which violates Regulation T. As plaintiff has pleaded in numerous paragraphs of the complaint, these purchases took place at *Winslow* (e. g., Paragraph Thirty-first in Count Fourth against Nusbaum and Winslow). Plaintiff impliedly concedes in his brief that Shearson has no liability directly under Section 3 and has not pleaded any purchase in violation of Regulation T while the accounts were at Shearson. Gumer asserts, however, that Shearson's liability for violation of Regulation T flows from the "principle and mandate" of Regulation T and of the *Pearlstein* case simply by reason of the transfer of plaintiff's account and Shearson's alleged knowledge of the alleged Regulation T violations which took place at Winslow. In support of Shearson's alleged duty plaintiff cites Sections 6(c), 6(d), 7(a) and 7(b) of Regulation T (12 C. F. R. §220 6. *et seq.*). Defendant will discuss below the applicability of each of these sections to the pleadings. (The relevant portions of Regulation T are reproduced in the Addendum hereto.)

Section 6(c).

Section 6(c) of Regulation T has no application to the facts alleged in the complaint. Section 6(c) relates to the effect of a guarantee of a customer's account for Regulation T purposes. The complaint makes no allegation that Shearson was in any way involved in the guarantee given by plaintiff to Winslow for his brother's and Pauline Rosenberg's accounts. Even the factual assertions contained in the brief make no claim that Shearson was in any way involved in the guarantee. Both the complaint and Gumer's brief (p. 14) assert liability only against Winslow. There is, therefore, no basis for Shearson's liability for violation of Section 6(c).

Section 6(d)(2).

Section 6(d)(2) of Regulation T has no application to the allegations against Shearson. Without having to interpret the operative language of Section 6(d)(2) it is obvious that it relates to the transfer of an account from one *customer* to another *customer*. In this case the only such transfer alleged is the consolidation of Gumer's account with his brother's, which took place at Winslow (Paragraph Forty-third). The *only* alleged connection between Shearson and the consolidation is that Shearson accepted the account *after* it had been consolidated. Such allegations are clearly insufficient to state violation of that section of Regulation T.

Plaintiff has made certain vague and conclusory assertions in his brief, as he did in the court below, regarding Shearson's involvement in the consolidation. While these assertions were not pleaded and are not properly before the court, it is useful to examine them assuming, *arguendo*, that plaintiff might add them to his complaint by amendment. Plaintiff states at page 16 of his brief:

> Shearson * * * agreed to accept a consolidated account containing all the securities and to refinance the combined debt of the three former accounts. In so doing it requested Winslow's act of consolidation * * *. Without that request and without Shearson's agreement to accept the combined accounts and to provide the refinancing for them there would have been no customer-to-customer transfer (consolidation) at Winslow. By thus participating in that consolidation Shearson violated subsection (2) as an arranger of the credit * * *.

In essence, even in Gumer's best statement of the factual situation, Shearson's alleged liability is predicated on an extended "but for" analysis. But for Shearson's acceptance of the consolidated account, Gumer would not have been injured by *Winslow*.

Gumer asks this court (Brief, p. 16, *infra*) to view Shearson's acceptance of the account as a "constructive" request for consolidation. This is much too remote an association with the act of consolidation to be the basis of liability. Most important, however, Section 6(d) as a whole has no application to plaintiff's allegations as more fully discussed below.

Section 7(a).

Plaintiff has failed to allege a violation by Shearson of Section 7(a) of Regulation T. Section 7(a) deals with the arrangement by a broker of credit for a customer. It usually applies to a situation where a broker attempts to arrange credit at a bank or other lending institution for the purpose of allowing the customer to purchase securities. The import of Section 7(a) is that the limitations upon a broker in extending credit also apply to the broker in any transaction in which he has made an arrangement with a third party for such credit for

a customer. Plaintiff asserts that Section 7(a) applies to the situation pleaded, in which *Winslow* consolidated the accounts of two of its own customers. Plaintiff asserts that this is a refinancing in which Winslow is arranging credit. The absurdity of that theory is apparent when one looks at the language of Section 7(a) which clearly draws a distinction between the creditor (the broker, Winslow, in this case) and some other person from whom credit is to be received. Obviously there was no credit arrangement. Winslow merely continued to extend credit as it had before.

Proceeding from this erroneous construction of 7(a), plaintiff further asserts that because Shearson agreed to accept the consolidated accounts, it was an "arranger of credit" under Section 7(a). This is the ultimate stretch of plaintiff's fertile imagination and a patent fiction. If assuming, *arguendo,* the transfer of the consolidated account amounted to an arrangement for credit then it was *Winslow* who was the arranger and the "creditor" to whom Section 7 applied.

Section 7(b).

Plaintiff has failed to allege a violation by Shearson of Section 7(b). Section 7(b) is that portion of Regulation T which explicitly excludes from the scope of the regulation any requirements regarding the maintenance of margin. There can be no violation of Section 7(b) under the facts as alleged.

Section 6(d)(1).

Plaintiff has failed to plead a violation by Shearson of Section 6(d)(1). The section of Regulation T which

appears to have most application to the instant action is Section 6(d)(1) which is set out below for convenience of the court.

> In the event of the transfer of a general account, special bond account, or special convertible security account from one creditor to another, such account may be treated for the purposes of this part as if it had been maintained for the transferee from the date of its origin: Provided, that the transferee accepts in good faith a signed statement of the transferor that no cash or securities need be deposited in such account in connection with any transaction that has been effected in such account or, in case he finds that it is not practicable to obtain such a statement from the transferor, accepts in good faith such a signed statement from the customer.

While this section by its terms applies to a "transfer of a general account" the operative language is not easily reconciled with the assertions in plaintiff's brief. The operative language of the section says "* * * *may be* treated for the purposes of this part as if it had been maintained by the transferee from the date of its origin * * *." (Italics supplied.) This is particularly precise and narrow language upon which to base a broad ranging civil liability which plaintiff alleges against Shearson.

Plaintiff, in its effort to apply the "principle and mandate" of Regulation T has completely missed the import of both Section 6(d)(1) and Section 6(d)(2). Section 6 of Regulation T is entitled "Certain Technical Details" and Section 6(d) is truly technical in nature. It applies, in connection with Section 3(b), to a situation where a customer wishes to make margin purchases after transfer of his account. A customer's ability to make such purchases is determined by the balance in his Special Miscellaneous Account which it is the customer of the trade

to maintain on behalf of any customer maintaining a margin account. This Special Miscellaneous Account (hereafter "SMA") is maintained pursuant to Section 4(f)(6) of Regulation T. Its function and its place in the securities business are amply described by Judge Pollack of the Southern District of New York in *Manevich v. Francis I. DuPont, Glore, Forgan and Co.*, 338 F. Supp. 1124 (1972), aff'd *per curiam* 465 F. 2d 1398 (2d Cir. 1972). The court's explanation of this Special Miscellaneous Account is as cogent as any possible:

> "* * * a Special Miscellaneous Account, a type of memorandum account employed not only by these brokers for each of their customers but by virtually all other brokerage firms as well.
>
> "The Special Miscellaneous Account, or SMA as it is popularly known, is an account which contains and from which is drawn, by an accounting transfer, the margin needed to comply with Regulation T whenever a purchase of securities is made partly on credit. The available credit balance in the SMA consists of cash deposited by the customer, dividends on securities held by the broker for the customers account, any available portion of the sales proceeds of securities sold in the margin account by the customer, and any appreciation in the market value of the securities held in the account over the price at which they were purchased."

The court, in a foonote, goes on to explain

> "3. That part of the SMA attributable to appreciation of the value of a security over the price at which it was purchased remains, according to the brokers, available even after a subsequent drop in the market price of that security. The theory underlying the maintenance of that part of the SMA, in the face of such a drop, is based on the fact that at the time of appreciation a customer may draw upon his SMA account in cash, if he

desires, to the extent of the appreciation. In that instance a subsequent drop would not require a return of these funds under Regulation T * * *" (pp. 1126-1127).

An understanding of the SMA is necessary to an understanding of the meaning and phraseology of Section 6(d) of Regulation T. The operative language "may be," which is permissive rather than directive, applies to the SMA during a *transfer* of accounts. A broker may or may not wish to allow, after transfer, further purchases based on the SMA balance. Any such purchases, absent the addition of cash or securities to the account, would reduce the maintenance margin (quite legally) and thus have an adverse impact on the broker's security for the amounts loaned to the customer. If the broker does wish to allow purchases through the SMA balance he may do so pursuant to the authority of Section 6(d).

The qualification contained in subsections (1) and (2) of Section 6(d) that the account may be treated as if it had been maintained "*from the date of its origin*" has meaning only in the context of the SMA. As Judge Pollack's description of the SMA clearly indicates, upward fluctuation in market prices of securities in the margin account can result in an increase in the SMA balance. On the other hand, downward fluctuations in market value in the margin account do not result in debit to the SMA because a customer would not be required under Regulation T to make additional deposits to its account to *maintain* a particular margin (Section 7[b]). Therefore, unless the SMA were treated as if maintained "from its date of origin," there could be no certainty by the transferee broker that there was any balance in such account which could be applied to the purchase of securities.

While a violation of Regulation T based on failure to comply with Section 6(d) could take place after transfer (assuming no additional deposit of cash or securities) by purchases based on a non-existent balance in the SMA, there is no necessary relationship between the status of the SMA and prior possible Regulation T violations in the margin account. Stated another way, if in securing a transferred account a broker did not comply with 6(d) the broker would have *no* assurance that the customer's SMA was not overstated by the amount of any deposits which were required but not made. SMA would be deemed to have a zero balance and subsequent *purchases* based on the SMA balance would violate Regulation T. On the other hand if no purchases were made in the account after transfer no violation could occur.

The plaintiff *has not alleged* that there were purchases after transfer to Shearson and therefore Section 6(d) has no application to the instant action.

If we attempt to apply the words of Section 6(d) to the facts as alleged by plaintiff, that of a transfer of an entire account by a customer from one broker to another, it is apparent that it was not intended to cover such a situation.

The language of Section 6(d) cannot be made to "fit" the situation where an account contains a security position generated in violation of Regulation T *before* transfer. First of all, the permissive *"may be"* language of the section is inconsistent with plaintiff's assertion of an absolute and continuing liability on the part of the transferee broker for the Regulation T violation. Furthermore, the operative language of "* * * treated for the purposes of this part as if it had been maintained by the transferee from the date of its origin." is patently inapplicable to an alleged Regulation T violation.

The operative portion of Regulation T, Section 3(b), says in pertinent part:

> "(1) a creditor shall not effect * * * any transaction which, in combination with the other transactions affected in such account on the *same day* in excess of the adjusted debit balance of such account over the maximum loan value * * *." (Italics supplied.)

Regulation T violations if they occur, occur on a day-to-day basis when a purchase is made with insufficient equity. Violations have no relationship to the overall *trading history* of the account and thus the language of Section 6(d) as it relates to the trading history of an account has no application to violations predating the transfer of an account. Most importantly, Section 6 contains no reference whatsoever to the liquidation requirements imposed by Section 3(e) on a broker who effects a transaction which would violate Section 3 of Regulation T if a deposit were not made within 5 days.

The principle and mandate of Regulation T and *Pearlstein v. Scudder and German*.

The foregoing analysis and Gumer's reliance in his brief on the "principle and mandate" of the law demonstrate amply that Regulation T does not speak to the facts presented in the allegations against Shearson. An examination of the purposes and language of Regulation T, as applied to these allegations against Winslow, demonstrate, by comparison, the applicability and scope of the regulation. Its nexus is Section 3(b) which prohibits the extension of credit in excess of prescribed amounts, on a day-by-day, transaction-by-transaction basis. Regulation T and *Pearlstein, supra,* direct the restriction on credit at those parties deemed most capable of preventing the abuse; that is, the customer and the broker who

implement the transaction. The remaining portions of the Regulation implement the basic thrust of Section 3(b), to prevent *purchases* of securities on excessive credit. If plaintiff's allegations are true he has his remedy against Winslow. All that remains of plaintiff's argument that Shearson is liable for the violations of Regulation T, which allegedly occurred at Winslow, is the bare assertion that by *accepting transfer* of the account, Shearson succeeded to Winslow's alleged liability under Section 3 for failure to liquidate. Neither the express language of Regulation T nor its purposes support plaintiff's theory.

Plaintiff presses upon this court not the language of Regulation T but the principle and mandate of the regulation and of *Pearlstein v. Scudder and German*, 429 F. 2d 1136 (2d Cir. 1970). The plaintiff makes much in his brief of this proposition that the *Pearlstein* case imposes absolute liability upon a broker for any violation of Regulation T. In urging this court to extend the scope of the limited language of Regulation T plaintiff seeks to expand the application of *Pearlstein* to a transferee broker. Extension of *Pearlstein* and the application of Regulation T would be improper for the following reasons, which are more fully discussed below: 1) the language of Regulation T does not clearly impose the liability asserted by the plaintiff; 2) the decision in *Pearlstein* exceeds the legislative intent; 3) the duties urged by the plaintiff are at odds with common sense and; 4) the policies which supported the decision of the court in the *Pearlstein* case can be adequately served without extending its application to a transferee broker.

In *Pearlstein* and the similar cases, finding a private right of action for violation of Regulation T, the courts could fall back upon the clear language of Section 3(b) and find a violation in the initial purchase of securities

or in the lending of money for such initial purchase. The courts could also clearly serve the regulatory purpose by imposing civil liability. Nevertheless, the court in *Pearlstein* had to reconcile its finding of civil liability with the statutory history. Judge Friendly, summarized the history of Section 7 as follows:

> "The legislative history of that section affords scant evidence that protection of the investor loomed at all large in the Congressional mind. Although passages in the Senate hearings and a later Senate report indicate that an important purpose of the Senate bill was 'to protect the margin purchaser by making it impossible for him to buy securities on too thin a margin,' the upper house was considering a bill that placed the administration of the credit requirements in the same agency, then the Federal Trade Commission, that was to enforce the rest of the securities exchange act. The change initiated by the House of Representatives and concurred in by the Senate, whereby determination of allowable credit was placed in the Federal Reserve Board has been said to demonstrate 'that concern for the investor was wholly subordinated to the achievement of macro-economic objectives,' in fact, the report of the House Committee, H. R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934) stated:
>
> "'The main purpose of these margin provisions * * * is not to increase the safety of security loans for lenders. Banks and brokers normally require sufficient collateral to make themselves safe without the help of law. Nor is the main purpose even the protection of the small speculator by making it impossible for him to spread himself too thinly—although such a result will be achieved as a byproduct of the main purpose.
>
> "'The main purpose is to give a Government Credit Agency an effective method of reducing the aggregate amount of the nation's credit resources

> which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry * * *'
>
> "While it thus may be wrong to say that concern for the investor was 'wholly subordinated' to the effect of excessive credit on the economy, the history surely does not indicate a Congressional desire that the courts should engage in an all out effort to utilize section 7(c) to protect investors against themselves, no matter how offensive the result. ([429 F. 2d 1147]. Accord *Pearlstein,* 295 F. Supp. 1197, 1202; *Remar v. Clayton Securities Corporation,* 81 F. Supp. 1014, 1017 [D. Mass. 1949])."

There is nothing in the legislative history of Regulation T or the facts alleged which would compel extension of *Pearlstein* and the extrapolation of Regulation T. The explicit language of Regulation T only requires that a transferee broker not itself commit violations by allowing purchases of securities on excessive credit.

Furthermore, the *Pearlstein* decision was rebutted by an amendment to the Securities Exchange Act which added Section 7(f) (Public Law 91-508, 84 Stat. 1114, approved October 23, 1970) which made it *equally* unlawful for the *customer* to obtain credit in violation of Regulation T. That law became effective by action of the Federal Reserve Board on November 1, 1971. While that section of the Act has no direct application to the matters alleged in the instant action, it demonstrates that the thrust of *Pearlstein* was clearly beyond Congressional intent in attempting to impose an absolute liability upon a broker for violation of Regulation T.

The requested imposition of liability on a transferee broker is impractical both in terms of enforcement by the court and in terms of compliance by the broker.

Since margin violations, if they occur, do so on a day-to-day basis, the only means for a transferee broker to ascertain if such violations have occurred is to compute the value of the transferred account for *every day* on which a purchase was made, using market price statistics *and* making *judgments* as to value where large blocks of stock or thinly traded issues are involved and then checking forward through the statements to determine if necessary deposits had been made within the prescribed five days. Such an audit would have to be done from the very inception of the account, with no guarantee of the accuracy of the transferor-broker's records. The burdens on a transferee broker would be immense in a case such as this, where there were nearly two hundred security positions which were very actively traded. Yet this is the burden plaintiff advocates, on a theory that the transferee broker should have the burden of knowing and liquidating all security positions generated in violation of Regulation T prior to transfer.

Finally the desires of the court to protect small investors and to insure compliance with Regulation T, as articulate in the *Pearlstein* case are adequately served by holding liable the broker whose action or inaction contributed to the violation, that is the initial purchase of securities on excessive credit. To achieve that purpose it is not necessary or proper to extend liability to a transferee broker who had no ability to prevent the transaction. Plaintiff's remedy, if his allegations are true, must come from Winslow which had responsibility for the accounts at the time the violations occurred.

The court should uphold the finding of the court below that the plaintiff has failed to state in Count Sixth a cause of action for violation of Regulation T.

Count Eighth.

The court should uphold the finding of the court below that the allegations of Count Eighth so far as they relate to a violation of Regulation T, fail to state a cause of action. The alleged actions of Shearson in allowing the account to deteriorate into a deficit position, for maintenance margin purposes, do not fall within the prohibitions of Regulation T and are in fact explicitly excluded therefrom by Section 7(b). They, therefore, do not give rise to the duty to liquidate "alleged" in the brief.

POINT III.

Plaintiff has failed to state a cause of action under the Federal Securities Laws by reason of alleged violations of New York Stock Exchange Rule 405.

Plaintiff's brief does not support his alleged cause of action for violation of New York Stock Exchange Rule 405.

The leading case on the question of a private right of action under the securities laws stemming from a violation of stock exchange rules is *Colonial Realty Corp. v. Bache & Co.*, 358 F. 2d 178 (2d Cir. 1966), cert. denied 385 U. S. 817. In that case, this Circuit affirmed the dismissal of a complaint which alleged, that in selling-out plaintiff's margin acount, the defendant had violated rules of The New Stock Exchange and of the National Association of Securities Dealers, Inc.

Under the *Colonial Realty* analysis, the test of federal jurisdiction over a violation of a stock exchange rule is

"the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of a statute or an SEC regulation * * *." *Id.* at 182, quoted in *Shemtob v. Shearson, Hammill & Co., Inc.* (CCH Fed. Sec. L. Rep. '70-'71 Decisions ¶93,036 [S.D.N.Y. 1971], aff'd 448 F. 2d 442 [2d Cir. 1971]).

Applying the *Colonial* analysis, the Third Circuit recently held that violations of New York Stock Exchange Rule 405 did *not* give rise to a private right of action. *Landy v. Federal Deposit Insurance Corporation,* 486 F. 2d 139 (3d Cir. 1973), cert. denied N. S. (1974). The Third Circuit said in analyzing implied private rights of action that implication of a private right of action under the federal securities laws was based

> "* * * upon explicit statutory condemnation of certain conduct, a general grant of jurisdiction to enforce liabilities created by the statute and a duty of the courts to effectuate the federal policies embodied in the Act. Courts thus normally consider the protection intended by the Legislature and the ineffectiveness of existing remedies, administrative, and judicial, fully to achieve that end" (citing *Colonial, id.* at 181) (p. 165).

The court went on to say:

> "We find no indication that the SEC or The NYSE consider Rule 405 part of the federal scheme to prevent fraudulent practises and protect investors. Indeed to the contrary what evidence we have been able to find in our own research points to an opposite conclusion" (p. 166).

Plaintiff cites the Seventh Circuit case of *Buttrey v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 410 F. 2d 135 (1969), cert. denied 396 U. S. 838, as the sole authority in support of his asserted cause of action. The *Buttrey* case, however, is limited in its holdings to the allegations before that court:

> "We do not decide that an alleged violation of Rule 405 is *per se* actionable. However, Count I pertains to the defendant's acceptance of investments without regard for the bankrupt broker's defalcations of investors funds * * *.
>
> "* * * the facts alleged here are tantamount to fraud on the bankrupt's customers thus giving rise to a private civil damage action" (*id.* pp. 142-143).

Even applying the *Buttrey* analysis, plaintiff has failed to state a cause of action. The allegations in the *Buttrey* case were that defendant had knowledge that the money used by its customer (another broker) "belongs to its (the other broker's) customer and was fraudulently converted" (*id.* p. 141). In contrast, plaintiff's brief asserts that Shearson knew or should have known that:

(a) the Louis Gumer and P. R. accounts were generated by Winslow in violation of Regulation T,

(b) the plaintiff had consolidated its accounts at Winslow under duress in violation of Regulation T (there is no allegation that Shearson participated in the coercion),

(c) the transfer of the consolidated account from Winslow would have violated Regulation T and was "unacceptable" under Rule 431.

The allegation that knowledge of a violation of other rules and regulations constitutes a violation of Rule 405, is merely a "bootstrap" argument. The logical extension of plaintiff's argument is that if the court dismisses the causes of action alleging violations of Regulation T, as it properly should (see Point II, *supra*) then it must also find that Rule 405 was not violated.

Plaintiff's allegations from another view constitute, at best, the assertion that Shearson knowingly violated certain technical rules and regulations by mere *acceptance* of the *transfer* of an account from defendant Winslow under circumstances where "plaintiff was compelled by the defendant (Winslow) to execute various agreements and to combine his account with the accounts of P. R. and Louis Gumer and to remove his account from the offices of defendant Winslow to the offices of defendant Shearson" (paragraph Twenty-first of the complaint, p. A-7). This assertion is in no way analogous to the fact situation alleged in *Buttrey* and certainly is not *tantamount to fraud* as required by the analysis of that case.

The cause of action alleged in Count Sixth so far as it alleges a cause of action under the federal securities laws for violation of Rule 405 of the New York Stock Exchange was properly dismissed.

POINT IV.

Plaintiff has failed to state a cause of action for violation of the Federal Securities Laws by reason of alleged violations of New York Stock Exchange Rule 431.

Plaintiff alleges in Count Eighth that Shearson failed to maintain a proper margin level in his account as re-

quired by New York Stock Exchange Rule 431 and that such failure is a violation of Rule 431 and the federal securities laws. This court is familiar with the distinction between purchase margin and maintenance margin and is aware that plaintiff is requesting that this court find, for the first time in the Second Circuit and for the first time in any reported case, that violations of Rule 431 give rise to a cause of action under the federal securities laws.

In analyzing plaintiff's argument, the court should remember its decision in *Colonial Realty*, where the court said:

> "* * * the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation" (p. 358 F. 2d at 182).

The plaintiff has manifestly failed to meet that burden.

Rule 431(b) provides:

The margin which must be maintained in margin accounts of customers, whether members, allied members, member organizations or non-members shall be as follows:

(1) 25% of the market value of all securities "long" in the account; plus

(2) $2.50 per share or 100% of the market value, in cash, whichever is greater of each stock "short" in the account selling at less than $5.00 per share; plus

(3) $5.00 per share or 30% of the market value, in cash, whichever amount is greater, of each stock "short" in the account selling at $5.00 per share or above; plus

(4) 5% of the principal amount or 30% of the market value, in cash, whichever amount is greater, of each bond "short" in the account.

First, plaintiff's brief has failed to come to grips with the fact that under the *Colonial Realty* analysis Rule 431 is not consistent with the federal regulatory scheme. Second, the plaintiff has failed to show that the alleged violations of Rule 431 fall within the purposes of the federal securities laws—that of preventing fraud. Third, the plaintiff has failed to distinguish his claim under Rule 431 from other kinds of controversies with brokers and dealers sufficiently to justify the federal courts taking jurisdiction of the controversy under the federal securities laws.

Rule 431 is plainly not consistent with the federal regulatory scheme. The Rule antedates the federal securities laws and is primarily concerned with the amount of collateral maintained by stock exchange members for the loans extended by them. The Securities Exchange Commission has never exercised any authority over stock exchange rules on margin maintenance and the Federal Reserve Board has specifically declined to regulate maintenance margin (Regulation T, §7[b]).

Second, plaintiff has failed to show how Rule 431 is directed at fraud, or under the analysis asserted in its own brief, that Shearson's violations were in fact "fraudulent" in the sense required by the securities laws. (*Colonial Realty v. Bache*, and *Landy et al., v. Federal Deposit Insurance Corporation.*)

The decision of the District Court in *Shemtob v. Shearson, Hammill and Co., Inc.* (CCH Fed. Sec. L. Rep. ¶93,036, affirmed 448 F. 2d 442 [2d Cir. 1971]), is directly in point. The trial court in *Shemtob* was considering a motion to dismiss a complaint which alleged, as a basis for civil liability under the securities laws, violations of Rule 431. The court, following the dictates of the Second Circuit in *Colonial*, said in part:

> "* * * although in *Colonial Realty* it was noted (at p. 182) that 'the case for implication (of federal liability) would be the strongest when the rule imposes an explicit duty unknown to the common law,' it has been pointed out that initially *Colonial* requires the court to determine if the * * * rule is consistent with the federal regulatory scheme * * *." *Mercury Investment Company v. A. G. Edwards & Sons*, 295 F. Supp. 1160 (S. D. Texas, 1969). The Texas court goes on to note:
>
> "On this point we merely note that the Securities Acts * * * are essentially directed at fraud—not against mere negligence or errors of judgment on the part of the broker * * * *Mercury* at 1163, quoting *Hecht v. Harris Upham & Co.*, 283 F. Supp. 417, 430 (N. D. Calif. 1968).
>
> "The *Hecht* and *Mercury* cases caution courts to avoid judicial review of market judgments and point out that exchanges seek to regulate a wider variety of activities than do the Federal Securities Laws (CCH Fed. Sec. L. Rep. p. 90844)."

Gumer's allegations of violations of Rule 431 as a basis for liability under the securities law are set forth in paragraph Sixty-seventh where he asserts that Shearson allowed his "account to deteriorate into a deficit position." He utterly failed to plead any fraud.

Even the sweeping allegations of Gumer's brief at pages 26 and 27, which are presumably his best statements of this case, allege no more than that Shearson failed to maintain a margin level of 25 per cent.

Thus, not only is Rule 431 not consistent with the purposes of the federal securities law but the violation pleaded is in no sense fraudulent as that term applies under the securities laws.

In considering whether a violation of Rule 431 should give rise to a private right of action the court should keep in mind that the contractual arrangement between the parties provides in paragraph "5" (p. A-28) that Gumer

> "* * * will maintain such margins as you (Shearson) may in your discretion require from time to time. * * *"

Finally, plaintiff's brief has failed to come to grips with a major policy reason against imputing civil liability under the federal securities laws in a case such as this. This court, in *Colonial Realty*, 358 F. 2d, beginning at page 182, said in part:

> "The consequences of the view urged (by the plaintiff) would be so disruptive as to require much more impressive evidence of Congressional purpose than we can discern. For example, as illustrated by this very case, the widely adopted prac-

tice of resorting to arbitration as a means of settling controversies between the stock brokers and their customers would be outlawed whenever the customer chose to rely not on breaches of contract or negligence *simpliciter*. * * * Moreover mere recitation of the statutory watchword by an aggrieved investor would saddle the federal courts with garden-variety customer-broker suits, even though the controversy was between citizens of the same state * * *" (pp. 182-183).

Count Eighth pleads a garden variety customer-broker dispute and so far as it purports to alleged a cause of action under the federal securities laws for violation of New York Stock Exchange Rule 431 was properly dismissed.

POINT V.

Plaintiff has failed to plead violations of SEC Rule 10b-5 in either Count Sixth or Count Tenth.

Plaintiff has alleged in Count Sixth that Shearson violated SEC Rule 10b-5 by accepting the transfer of plaintiff's account from defendant Winslow. Plaintiff has further alleged in Count Tenth that defendant Shearson violated SEC Rule 10b-5 in the course of the trading in plaintiff's account while it was at Shearson.

In reviewing the sufficiency of the complaint, the court should not be misled by the board and sweeping language in Point IV in plaintiff's brief which is often conclusory and goes well beyond the pleadings in the complaint. The court should also carefully assess the plaintiff's various arguments that it has pleaded *scienter* or that it has pleaded a scheme to defraud to practice or course of business which operate as a fraud. The

plaintiff, in its argument, often confuses pleading of conclusory "statutory watchwords" with the pleading of *facts*.

> * * * mere conclusory allegations to the effect that defendant's conduct was fraudulent or in violation of Rule 10b-5 are insufficient. *Pauling v. McElroy*, 107 U. S. App. D. C. 372, 278 F. 2d 252 (1960); *Dunn v. Gazolla*, 216 F. 2d 709 (1st Cir. 1954); See 2a Moore Federal Practice, paragraph 12.08. Rule 9(b). F.R.C.P. provides that "in all averments of fraud * * * the circumstances constituting fraud shall be stated with particularity."
>
> * * *
>
> "The sufficiency of the complaint in the present case and the existence of federal jurisdiction depend upon the underlying factual claims. * * *" (*Shemtob*, 448 F. 2d 442, 444-445 [2d Cir. 1971]).

Count Sixth.

Gumer's arguments beginning at page 28 of its brief are inadequate to sustain his alleged cause of action in Count Sixth for violation of SEC Rule 10b-5. The essential *factual* allegations of Count Sixth are that Shearson accepted the transfer of Gumer's consolidated account from Winslow. Gumer then argues that merely by accepting the transfer, Shearson constructively participated in the consolidation (paragraph Fifty-third p. A-15). In addition to the allegations of the complaint, plaintiff would have the court take notice of the "context" of his allegations (Plaintiff's Brief, p. 30) though plaintiff has not pleaded a "context." With or without context, plaintiff's factual allegations are not sufficient to state a cause of action.

Gumer first asserts that he has pleaded a violation of SEC Rule 10b-5 because the events which are the subject of the complaint touch upon the purchase or sale of

securities. He argued to the court below that the consolidation of the plaintiff's account with those of his brother and P. R. at *Winslow* constituted a purchase and sale. He asserts to this court that the "economic reality" of a transfer and acceptance is that it is a purchase or sale of securities. In a flight of fancy the plaintiff also argues (Plaintiff's Brief, p. 29) that the establishment of a margin account is a security, and, therefore, that the transfer constitutes a purchase or sale of that "security" (Plaintiff's Brief, p. 30).

Plaintiff's arguments are merely a request of the court to create a *fiction* in order to support his theory of federal jurisdiction. The court below properly rejected plaintiff's insubstantial and meritless arguments.

The terms purchase and sale are not defined in SEC Rule 10b-5 but are defined in Section 3(a)(13) and (14) of the Securities Exchange Act under the authority of which SEC Rule 10b-5 was promulgated. Those subsections provide in pertinent part:

> (13) The terms "buy" and "purchase" each include any contract to buy, purchase or *otherwise acquire.*
>
> (14) The terms "sale" and "sell" each include any contract to sell or otherwise *dispose of.*"

The operative terms are "acquire" and "dispose of" and yet the economic reality of the transfer which is the subject of Count Sixth was that Gumer owned the securities in the accounts when they were at *Winslow* and he owned the securities in the accounts after the transfer to Shearson. No securities were either "acquired" or "disposed of" in the course of that transfer.

Quoting the Supreme Court in *Tcherepnin v. Knight*, 389 U. S. 332 (1967), which plaintiff cited in his brief:

> * * * security "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes *devised by those who seek the use of money of others on the promise of profits*" (citation omitted; italics supplied) (p. 338).

Even that broad principle does not encompass plaintiff's theory, for the economic reality of the transaction is that it is the plaintiff who has the money of others (the margin loan from his brokers) to use in search of profit. Plaintiff's theory that the transfer was a purchase or sale is simply too far fetched to support his cause of action.

Thus in the transfer from Winslow to Shearson, plainly, there was no purchase or sale of the securities and plaintiff's allegation of a violation of SEC Rule 10b-5 was properly dismissed on that basis alone.

Gumer next argues that the scheme or material omission which violated SEC Rule 10b-5 is found in Shearson's alleged knowing violation of Regulation T and its failure to disclose to plaintiff that it was violating the regulation. This is another "bootstrap" theory at best. The so-called fact of a violation of a statute or regulation is not a fact at all but a legal conclusion. If Gumer has pleaded a violation of Regulation T (which Shearson strongly disputes in Point II, hereof) a violation of Rule 10b-5 with its complications of proving *scienter* and reliance offers him no advantage over his alleged private right of action under SEC Regulation T. If on the other hand there was no violation of Regulation T, there is no violation of SEC Rule 10b-5 for there are no other facts

alleged which constitute either a scheme to defraud or an omission to state material facts.

The argument is similar with respect to the alleged violations of New York Stock Exchange Rules 405 and 431 as constituting violations of SEC Rule 10b-5 except that in addition, if there are no private rights of action under the federal securities laws for violations of these rules (see Points II and III, *supra*) a "backdoor" theory of federal jurisdiction under SEC Rule 10b-5 for violations of exchange rules makes no sense whatever. Violations of those rules either are or are not actionable on their own. The pleading of a violation of SEC Rule 10b-5 adds nothing to plaintiff's argument.

Plaintiff argues that he alleged a single scheme to consolidate and transfer his account (Plaintiff Brief, p. 31) and yet, as a reference to the factual allegations in Count Sixth of the complaint will demonstrate, repeatedly plaintiff has failed to plead *facts* which connect Shearson with any scheme to defraud.

Plaintiff's extensive discussion of cases on the questions of *scienter*, while interesting in theory, ignore the fundamental proposition that it is the *facts* which are pleaded which must sustain a cause of action and not the theory or conclusions of counsel (*Shemtob v. Shearson, Hammill & Co., Inc.*, 448 F. 2d 442 [2d Cir. 1971]).

Gumer has simply pleaded that after Winslow had committed certain acts and omissions which are alleged to be violations of various status, rules and regulations, Shearson accepted the transfer of his account when Shearson knew or should have known of the alleged prior violation at Winslow.

In a last gasp, Gumer, at page 31 of his brief introduces yet another theory, one that is not pleaded and which was not argued before the court below: that Shearson aided and abetted Winslow's violations. The fatal flaw in such a theory is that plaintiff acknowledges in his complaint that *all* the violations committed by *Winslow* took place *before* the transfer of the account to Shearson. Gumer's only argument is that Winslow would not have consolidated the accounts (though this made no material change in plaintiff's position as he had already guaranteed his brother's and P. R.'s account) had Shearson not accepted the transfer of the account.

Gumer cites *Brennan v. Midwestern United Life Insurance Co.*, 259 F. Supp. 673 (N. D. Ind. 1966) (motion to dismiss denied), 286 F. Supp. 702 (N. D. Ind. 1968) (on merits), aff'd 417 F. 2d 147 (7th Cir. 1969), cert. denied, 397 U. S. 989 (1970). The holding of that case is based in part upon the Restatement of Torts §876 (1939) which provides in pertinent part:

876. Persons Acting in Concert

For harm resulting to a third person from the tortious conduct of another, a person is liable if he

(a) orders or induces such conduct, knowing of the conditions under which the act is done or intending the consequences which ensue, or

(b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or

(c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.

Gumer has not alleged any acts by Shearson, even in the "allegations" of his brief, which would give rise to liability under Restatement §876. There are no facts pleaded which show that Shearson either induced or gave substantial assistance to Winslow's acts.

The *Brennan* case and other cases on aiding and abetting are ably discussed in Ruder, *Multiple Defendants in Securities Law Fraud Cases,* 120 U. Pa. L. Rev. 597 (1972) where the author concludes that the Restatement §876 should be relied upon cautiously in finding civil liability under the securities laws (*Id.*, p. 621). Furthermore, the author concludes from an analysis of the SEC enforcement cases and the criminal cases which have dealt with the concept of aiding and abetting that liability does not attach if the defendant merely fails to take action (*Id.*, p. 645).

Shearson's *acceptance* of the transfer of the account as alleged by plaintiff is not in any way action which aided or abetted the violations which occurred at Winslow.

Count Tenth.

Gumer's basic claim, in Count Tenth, is that Shearson violated its contractual duties to him under his customer agreement. He has pleaded that theory in Count Eleventh (p. A-20). Gumer has attempted to force his claim into the confines of the Securities Acts and more particularly

SEC Rule 10b-5 in an attempt to avoid his agreement to arbitrate disputes arising under his customer's agreement. (See Affidavits of Hoblin, Kelly and Richard, A-24 *et seq.*) While requiring considerable imagination to comprehend, this approach is not new and has been repeatedly rejected by the courts.

In the *Colonial Realty* case, the plaintiff alleged breach of contract, negligence and violations of the Securities Acts by reason of violation of a New York Stock Exchange rule when the defendant in that action allegedly sold-out plaintiff's margin account after margin fell below the level of thirty per cent set by defendant. The plaintiff relied on an alleged oral agreement that defendant, Bache, would not require a margin level in excess of the minimum requirements of the New York Stock Exchange. In affirming the District Court's dismissal of the complaint Judge Friendly made the following observations:

> The complaint alleged simply that Bache's dealings were not consistent with such principles without elaborating how, save insofar as this can be gleaned from the charges of breach of contract and of failure to use due care to protect its customer's interests (358 F. 2d at p. 180-181).
>
> * * *
>
> Moreover, mere recitation of the statutory watchword by an aggrieved investor would saddle the federal courts with garden-variety customer-broker suits * * * (*Id.*, p. 183).

Judge Friendly's words apply equally well to the complaint in this action. Count Tenth of the complaint alleging a violation of SEC Rule 10b-5, contains only four paragraphs numbered "Seventy-Third" through "Seventy-Seventy" *(sic)*. The first of these repeats and realleges the same paragraphs alleged to support plaintiff's cause

of action in *negligence, and breach of contract.* The last of the four paragraphs contain plaintiff's demand for relief. The remaining two paragraphs "Seventy-Fourth" and "Seventy-Fifth," which are set out below for convenience, contain the crux of the plaintiff's allegations of violation of SEC Rule 10b-5.

> *Seventy-Fourth:* That plaintiff believed that defendant Shearson Hammill was controlling his account as said defendant said it was and was maintaining the requisite minimum margin prescribed by Rule 431 of the N.Y.S.E., all in accordance with defendant Shearson's representations. Defendant Shearson knew or should have known that plaintiff's account was not being properly maintained and made the contrary representations knowingly or recklessly without knowing whether they were true and without properly controlling plaintiff's account, which duty they had assumed.

> *Seventy-Fifth:* That the breach of the duty assumed, the representations made by the defendant Shearson to the plaintiff, and the act of permitting plaintiff's account to fall far below minimum maintenance requirements and into a deficit position amounted to such gross negligence that it was a scheme and course of conduct to defraud and did in fact operate as a fraud and deceit upon the plaintiff, all within the meaning and prohibited by Section 10 of the 1934 Act and Rule of 10b-5 of the SEC.

These two new paragraphs simply allege the "representations" set out in paragraphs Fifty-Fifth through Fifty-Eighth (Count Seventh "in negligence") and allege knowledge or "recklessness" and again allege "negligence." Allegations of negligence do not state a violation of SEC Rule 10b-5. *Globus v. Law Research Service, Inc.,*

418 F. 2d 1276, 1290-91 (2d Cir. 1969) cert. denied 397 U. S. 913; *Lanza v. Drexel & Co.*, 479 F. 2d 1277 (2d Cir. 1973).

Plaintiff's allegations are that defendant Shearson mishandled plaintiff's account in certain specified ways. The representations alleged in paragraphs Seventy-Fourth and Seventy-Fifth contain a "mere recitation" of the "statutory watchwords"—"fraud and deceit," are no different in kind than those alleged in the *Colonial* case and add nothing to plaintiff's basic claim. Plaintiff makes no allegation of fact indicating fraudulent intent or *scienter* in not enforcing margin maintenance requirements.

This court has recently reviewed the decision of a district court dismissing a complaint which pleaded strikingly similar facts. *Shemtob v. Shearson, Hammill & Co.*, CCH Fed. Sec. L. Rep. '70-'71 Decisions ¶93,036 (S.D.N.Y., 1971), affirmed 448 F. 2d 442 (2d Cir. 1971).

Plaintiffs in the *Shemtob* case purchased a stock on margin. There were no allegations of violations of Regulation T. Several months later (and during the same time period involved in the instant action) the margin in plaintiff's account dropped below defendant's 30% house rule and soon thereafter on April 27, 1970, it dropped below the 25% minimum margin requirements of the American Stock Exchange Rule 462(b) (equivalent to Rule 431 of the New York Stock Exchange). The District Court's statement of ensuing events, which events bear a striking resemblance to the facts alleged in the instant complaint, are set out below:

> About a month before and on or about April 22, 1970, defendant had written to plaintiffs demanding an additional margin in the amount of $13,833 in order to conform to the margin requirements of the N.Y.S.E. and of the firm. The following en-

> sued: On or about May 1, 1970, defendant sent plaintiffs a telegram demanding additional margin of $13,850, stating that unless the deposit was received by May 4, 1970, at noon, defendant would sell for plaintiffs' account sufficient securities to comply with the N.Y.S.E. margin. On May 4, 1970, plaintiff Richard Shemtob telephoned defendant's representative telling him that he (Shemtob) was prepared to "ride the market down" and asking for the opportunity to cover any margin calls by supplying additional cash or securities. According to plaintiff, defendant's representative agreed to this request. Plaintiff then telephoned an order to E. F. Hutton & Co. directing that firm to deliver an additional 1,000 shares of Asamera to defendant in order to bring plaintiff's account within permissible margin limits.
>
> This stock was not delivered until May 13, 1970, by which time Asamera stock had so declined in value that the additional shares were insufficient to bring plaintiff's account within permissible margin limits. Defendant made no additional margin calls but on May 22, 1970, sold plaintiffs' entire block of Asamera stock (14,800 shares) at $7 1/2 per share without notice to plaintiffs.

Plaintiffs alleged that these facts constituted a violation of SEC Rule 10b-5.

The court went on to say:

> Plaintiffs have no complaint cognizable under 10b-5. Reduced to its essentials, plaintiffs claim is that defendant failed to sell out plaintiff's account until defendant deemed itself to be in financial jeopardy. *Yet such action is clearly contemplated by the agreement between the parties:*
>
> 5. I (plaintiffs) will maintain such margin as you (defendant, Shearson) in your discretion may require from time to time and will pay on demand

any debit balance owing with respect to any of my accounts. You may, in the event of my death or *whenever in your discretion you consider it necessary for your protection,* sell any or all property held in any of my accounts, cancel any open orders for the purchase or sale of any property with or without notice to me, and you may borrow or buy in any property required to make delivery against any sale effected for me. Such sale or purchase may be public or private and made without advertising or notice to me * * *.

* * *

11. Your failure to insist at any time upon strict compliance with this agreement * * * shall in no event constitute or be considered a waiver by you of any of your rights or privileges * * *. (Agreement, Feb. 4, 1969; emphasis supplied.) (CCH Fed. Sec. L. Rep. '70-'71 Decisions ¶93,036, pp. 90,843-90,844.)

This agreement is identical to that signed by the plaintiff in his action (see affidavit of Kelly and Richard, A-29 *et seq.*).

Judge Mansfield's opinion for this court in the *Shemtob* case is equally enlightening and directly applicable to the instant action. Judge Mansfield said:

> * * * *However, mere conclusory allegations to the effect that defendant's conduct was fraudulent or in violation of Rule 10b-5 are insufficient. Pauling v. McElroy,* 278 F. 2d 252 (D.C. Cir. 1960); *Dunn v. Gazzola,* 216 F. 2d 709 (1st Cir. 1954); see 2A *Moore, Federal Practice,* §12.08 Rule 9(b), F.R.C.P. provides that *"In all averments of fraud * * * the circumstances constituting fraud * * * shall be stated with particularity."*
>
> The sufficiency of the complaint in the present case, and the existence of federal jurisdiction, *depend upon the underlying factual claims concerning alleged improper representation made to plain-*

> *tiff*, which are found in §§ 17, 18 and 19. These allegations, even when accepted as true and construed liberally and most favorably to the pleader, amount to a claim that Shearson failed to sell out the Shemtobs promptly, as stated in Shearson's May 1 telegram (even though the underlying February 4, 1969, agreement gave Shearson wide discretion in this respect) and that Shearson eventually sold them out without giving them an opportunity to post additional margin, in breach of the alleged May 4, 1970, oral "novation" or modification of the February 4, 1969, written agreement. *Thus plaintiff's claim is nothing more than a garden-variety customer's suit against a broker for breach of contract, which cannot be bootstrapped into an alleged violation of 10(b) of the Exchange Act, or Rule 10b-5, in the absence of allegation of facts amounting to scienter, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud. It is insufficient to allege mere negligence. SEC v. Texas Gulf Sulphur,* 401 F. 2d 833, 867-68 (2d Cir. 1968); *Globus v. Law Research Service, Inc.,* 418 F. 2d 1276, 1290-91 (2d Cir. 1969), *breach of contract or breach of a stock exchange rule, Colonial Realty Corp. v. Bache & Co.,* 358 F. 2d 178 (2d Cir.), cert. denied, 385 U. S. 817 (1966). (Italics supplied. Footnotes omitted.) (448 F. 2d at p. 444-445.)

Count Tenth was properly dismissed for failure to state a cause of action.

POINT VI.

Pendent jurisdiction.

Plaintiff does not contest the finding of the court below that Counts Seventh, Ninth and Eleventh, alleging negligence, fraud, breach of fiduciary duty and breach of

contract respectively were properly dismissed for lack of subject matter jurisdiction.

Because jurisdiction is based on the existence of a federal question, if the court affirms the dismissal of plaintiff's causes of action for alleged violations of federal securities laws, the court must necessarily dismiss plaintiff's common-law causes of action as well. *United Mine Workers v. Gibbs*, 383 U. S. 715.

POINT VII.

Arbitration.

If plaintiff's spurious federal securities law claims are dismissed, as they should be, there is no bar to the submission of the remaining allegations regarding management of plaintiff's account to arbitration in accordance with the agreement executed by Gumer and Shearson. The Agreement provides that:

> 10. This agreement shall inure to the benefit of your successors and assigns, shall be binding on the undersigned, his heirs, executors, administrators and assigns and shall be governed by the laws of the State of New York. Any controversy arising out of or relating to my account, to transactions with you for me, or to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules, then in effect, of the American Arbitration Association or the Board of Governors of the New York Stock Exchange as I may elect. If I do not make such election by registered mail addressed to you at your main office within 5 days after demand by you that I make such election, then you may make such election. Judgment upon

any awards rendered by the arbitrators may be entered in any court having jurisdiction thereof.

As the affidavit of David W. Kelly (p. A-29) and the exhibits thereto demonstrate, the required demand and elections were made by Shearson.

The Federal Arbitration Act, 9. U.S.C. and New York CPLR Article 75 render agreements to arbitrate disputes such as the one before this court enforceable. It is, therefore, the policy of the State of New York and of Congress to encourage arbitration where provided by agreement.

The controversy presented by this action is one which should properly be decided by arbitration rather than by the more time consuming and expensive process of a lawsuit. Plaintiff's account contained more than 180 separate security positions and the transactions complained of involved more than a thousand individual market transactions. The complaint puts in issue the value of each of these security positions on each date during the many months, prior to liquidation, that plaintiff's account was with defendant. The complaint also appears to put in issue the propriety of each of the individual transactions undertaken in the same period. Judicial determination of these issues would be tremendously time consuming.

It was in anticipation of just this kind of controversy, and a desire to secure speedy resolution of such controversies, that led defendant Shearson to require agreement to arbitration in its customer agreements (Affidavit of Hoblin, A-24).

If Counts Sixth, Seventh, Eighth, Tenth and Eleventh are dismissed, plaintiff's claims may proceed to arbitration.

POINT VIII.

The District Court properly dismissed the complaint and denied leave to amend.

In Points V and VI of his brief, Gumer asserts that the trial court erred in dismissing his claim and in denying leave to amend the complaint. Plaintiff's assertions are unfounded.

The court below recognized that plaintiff's complaint contained, in the words of the Supreme Court in *Conley v. Gibson,* 355 U. S. 41, 47 "* * * a short and plain statement of the claim." The trial court in reviewing the facts alleged properly concluded that they did not state causes of action under the federal securities laws.

Plaintiff's brief to the court below, as well as his brief to this court, contained assertions of fact well beyond the bounds of a complaint. After reviewing those assertions at the request of Shearson, the court below properly found that no federal claims had been stated. That plaintiff asserted in its brief, facts beyond the complaint was the rationale offered by Shearson to the court below in support of Shearson's request that leave to amend be denied.

The flaw in Gumer's arguments in both Point V and Point VI of his brief is that the basic transactions which he has pleaded, the transfer of his account and the management of it thereafter are not the subject of civil liability under the federal securities laws but are garden-variety customers broker disputes which can and should be dealt with through arbitration and in the state courts. This is a firm policy which has been consistently recognized by this court since its decision in *Colonial Realty* and as recently as its decision in *Shemtob.*

Plaintiff has not, by the District Court's decision been deprived of the possibility of recovering from Shearson on his claims. The District Court has simply refused to burden the Federal Courts with litigation which fails to raise a federal question.

Conclusion.

The order of the District Court dismissing plaintiff's complaint against Shearson should be affirmed in all respects or in the alternative the District Court findings under Fed. R. Civ. P. 54(b) should be reversed and the appeal dismissed.

Respectfully submitted,

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September 9, 1974

ADDENDUM.

Relevant Portions of Regulation T (12 C.F.R. §220).

§3 (b) *General rule.* (1) A creditor shall not effect for or with any customer in a general account, special bond account subject to §220.4(i), or special convertible security account any transaction which, in combination with the other transactions effected in such account on the same day, creates an excess of the adjusted debit balance of such account over the maximum loan value of the securities in such account, or increases any such excess, unless in connection therewith the creditor obtains, as promptly as possible and in any event before the expiration of 5 full business days following the date of such transaction, the deposit into such account of cash or securities in such amount that the cash deposited plus the loan value of the securities deposited equals or exceeds the excess so created or the increase so caused.

§3 (e) *Liquidation in lieu of deposit.*[3] In any case in which the deposit required by paragraph (b) of this section, or any portion thereof, is not obtained by the creditor within the 5-day period specified therein, margin non-exempted securities shall be sold (or, to the extent that there are insufficient margin non-exempted securities in the general account, special bond account, or special convertible security account other liquidating transactions shall be effected in such account), prior to the expiration of such 5-day period, in such amount that the resulting decrease in the adjusted debit balance of such account exceeds, by an amount at least as great as such required deposit or the undeposited portion thereof, the "retention requirement" of any margin or exempted securities sold: *Provided,* That a creditor is not required to sell securities or to effect other liquidating transactions specified by this paragraph in an amount greater

than necessary to eliminate the excess of the adjusted debit balance of such account over the maximum loan value of the securities remaining in such account after such liquidation.

§4(f) (6) Effect for any customer the collection or exchange (other than by sale or purchase) of securities deposited by the customer specifically for such purposes, and (subject to any other applicable provisions of law) receive from or for any customer, and pay out or deliver to or for any customer, any money or securities;

§6 (c) *Guaranteed accounts.*—No guarantee of a customer's account shall be given any effect for purposes of this part.

§6 (d) *Transfer of accounts.*—(1) in the event of the transfer of a general account, special bond account, or special convertible security account from one creditor to another, such account may be treated for the purposes of this part as if it had been maintained by the transferee from the date of its origin: *Provided,* That the transferee accepts in good faith the signed statement of the transferor that no cash or securities need be deposited in such account in connection with any transaction that has been effected in such account or, in case he finds that it is not practicable to obtain such a statement from the transferor, accepts in good faith such a signed statement from the customer.

(2) In the event of the transfer of a general account, special bond account, or special convertible security account from one customer to another, or to others, as a bona fide incident to a transaction that is not undertaken for the purpose of avoiding the requirements of this part, each such transferee account may be treated by the creditor for the purposes of this part as if it had been maintained for the transferee from the date of its origin:

Provided, That the creditor accepts in good faith and keeps with such transferee account a signed statement of the transferor describing the circumstances giving rise to the transfer.

§7 Miscellaneous provisions.—(a) *Arranging for loans by others.*—A creditor may arrange for the extension or maintenance of credit to or for any customer of such creditor by any person upon the same terms and conditions as those upon which the creditor, under the provisions of this part, may himself extend or maintain such credit to such customer, but only upon such terms and conditions, except that this limitation shall not apply with respect

(b) *Maintenance of credit.*—Except as otherwise specifically forbidden by this part, any credit initially extended without violation of this part may be maintained regardless of (1) reductions in the customer's equity resulting from changes in market prices, (2) the fact that any security in an account ceases to be margin or exempted, and (3) any change in the maximum loan values or margin requirements prescribed by the Board under this part. In maintaining any such credit, the creditor may accept or retain for his own protection additional collateral of any description, including non-margin securities.

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